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No. 07-998

In the
Supreme Court of the United States

CIRCUIT CITY STORES, INC.,

Petitioner,

v.

ROBERT GENTRY,

Respondent.

On Petition for Writ of Certiorari to the California Supreme Court

BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. Whether the Federal Arbitration Act permits a court to refuse to enforce an agreement calling for individual arbitration based on state labor law policies that do not apply generally to "any contract." 9 U.S.C. § 2.

2. Whether the Federal Arbitration Act permits a state court to refuse to enforce an agreement to arbitrate based upon an unconscionability analysis "that takes its meaning precisely from the fact that a contract to arbitrate is at issue." *Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987).

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INTEREST OF AMICUS CURIAE

PLF was founded 35 years ago and is widely recognized as the largest and most experienced nonprofit legal foundation of its kind. PLF litigates matters affecting the public interest at all levels of state and federal courts and represents the views of thousands of supporters nationwide. Among other things, PLF's Free Enterprise Project defends the freedom of contract, including the right of parties to agree by contract to the process for the resolution of disputes between them. To that end, PLF has participated as amicus curiae in many important cases involving the Federal Arbitration Act and freedom of contract in general, including *Hall Street Associates L.L.C. v. Mattel, Inc.*, pending docket no. 06-989; *Preston v. Ferrer*, No. 06-1463, 2008 WL 440670 (U.S., Feb. 20, 2008); *Cingular Wireless, LLC v. Mendoza*, 126 S. Ct. 2353 (2006); and the proceedings in this case in the California Supreme Court. *Gentry v. Superior Court*, 42 Cal. 4th 443 (2007).[1]

INTRODUCTION AND SUMMARY OF ARGUMENT

In *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006), this Court reaffirmed that Congress enacted the Federal Arbitration Act (FAA), 9 U.S.C. §§ 1-16, to overcome judicial resistance to

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[1] Written consent was granted by counsel for all parties and lodged with the Clerk of this Court. All parties were notified of PLF's plan to file this brief more than 10 days before the due date. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae, its members, or its counsel made a monetary contribution to its preparation or submission.

arbitration and that the savings clause of Section 2 embodies the national policy favoring arbitration and places arbitration agreements on equal footing with all other contracts. Applying this federal substantive law to the states, this Court held that arbitration contracts are to be construed as any other contract, not subjected to more stringent review or disfavor because the subject matter is arbitration. The Court thus confirmed the holding of *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984).

These matters have been settled law for more than 20 years. California courts, however, still scrutinize arbitration with suspicion and dislike, and invalidate arbitration contracts with distressing regularity. Most commonly, California courts invoke unconscionability principles to invalidate the contracts. However, the unconscionability doctrine is not applied neutrally among all types of contracts, resulting in the disproportionate invalidation of arbitration provisions as opposed to other contracts. This feature of California jurisprudence interferes with the normal and proper functioning of the California marketplace, injuring businesses and consumers alike. Because employment contracts—including arbitration clauses—are ubiquitous throughout California, and because California courts are invalidating arbitration clauses at a rate far exceeding that of any other state, this case presents an important question that can be resolved only by this Court. The petition for writ of certiorari should be granted.

REASONS FOR GRANTING THE WRIT

I

CALIFORNIA'S UNCONSCIONABILITY DOCTRINE UNIQUELY DISFAVORS ARBITRATION CONTRACTS

California's reluctance to enforce arbitration contracts conflicts with the Federal Arbitration Act's policy of favoring arbitration. It also conflicts with the approach of other states and the federal circuit courts, which comply with the federal policy codified in the FAA. Because California's hostility toward arbitration contracts affects many millions of employees and businesses in the country's most populous state, this Court should grant the writ of certiorari to review and reverse the decision below.

With one procedurally bizarre and narrow exception, there is no statute in California, or any other state, that requires parties to a transaction to arbitrate disputes.[2] Nonetheless, arbitration frequently is described as "mandatory," by which those who oppose arbitration contracts generally mean either that (1) individuals must agree to arbitration if they wish to buy the product or continue being employed; or (2) by agreeing to arbitrate, the contract "mandates" individuals to resolve disputes by arbitration even if they later would prefer to go to court. Christopher R.

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[2] *See Hess Collection Winery v. Agricultural Labor Relations Board*, 140 Cal. App. 4th 1584, 1600-01 (Cal. Ct. App. 2006), *rev. denied* (Sept.13, 2006) (upholding validity of Cal. Labor Code § 1164, mandating "interest" arbitration (as opposed to "grievance" arbitration) between agricultural employer and workers, which compels the parties to submit to mediation imposing a collective bargaining agreement when the parties fail to agree on the terms of an initial bargaining agreement).

Drahozal, *"Unfair" Arbitration Clauses*, 2001 U. Ill. L. Rev. 695, 706 (2001). This Court, however, has refused to invalidate arbitration agreements solely on the grounds that an individual must take-it-or-leave-it. *See Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 33 (1991) ("Mere inequality in bargaining power, however, is not a sufficient reason to hold that arbitration agreements are never enforceable in the employment context.");[3] *see also Pritzker v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 7 F.3d 1110, 1118 (3d Cir. 1993) (arbitration agreements are enforceable even if they involve unequal bargaining power). *Cf. Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 596-97 (1991) (upholding a forum-selection clause in cruise-line ticket).

One way that individuals seek to evade an arbitration provision in a contract is to invoke the unconscionability doctrine. Unconscionability is a notoriously flexible concept. *See* Joseph M. Perillo, Corbin on Contracts: Avoidance & Reformation § 29.1 (rev. ed. 2002) ("Unconscionability is one of the most

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[3] In 2002, Senator Edward Kennedy introduced a bill expressly to restrict the FAA to nonemployment agreements. S. 2435 (107th Cong.) (2002) ("A bill to amend title 9 of the United States Code to exclude all employment contracts from the arbitration provisions of chapter 1 of such title; and for other purposes.") *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d107:SN02435:@@@L&summ2=m& (last visited Feb. 11, 2008). This bill has since been reintroduced and referred to committee five times, but never made it out of committee. *See e.g.*, H.R. 2969 (109th Cong.) (2005) ("Preservation of Civil Rights Protections Act of 2005 – Amends the Federal Arbitration Act to modify the definition of commerce so as to exclude employment contracts from arbitration provisions"), bill history *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d109:HR02969:@@@L&summ2=m& (last visited Feb. 11, 2008).

amorphous terms in the law of contracts."). The flexibility no doubt stems from the original purpose of the unconscionability doctrine: to protect consumers. Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. L. & Econ. 293, 302 (1975) ("Ideally, the unconscionability doctrine protects against fraud, duress and incompetence, without demanding specific proof of any of them."). However, the doctrine was not written to enable courts to do justice by rewriting contracts. In fact, in the official comments to Uniform Commercial Code § 2-302, the drafters explained that the unconscionability principle "is one of prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power." *See id.*, official comment 1 (emphasis added); *accord* Cal. Civ. Code § 1670.5, Legis. Comm. Cmt. (same).

While the FAA permits state courts to apply "ordinary principles of unconscionability," the FAA forbids state courts from implementing substantive state policies that undermine arbitration clauses. Moreover, "a state cannot evade FAA preemption simply by labeling procedures which are inconsistent with its substantive policies as unconscionable." Alan S. Kaplinsky and Mark J. Levin, *The Gold Rush of 2002: California Courts Lure Plaintiffs' Lawyers (but Undermine Federal Arbitration Act) by Refusing to Enforce "No-Class Action" Clauses in Consumer Arbitration Agreements*, 58 Bus. Law. 1289, 1295 (2003). Similarly, this Court's arbitration jurisprudence does not permit a state to use unconscionability as a ground for voiding arbitration agreements in certain classes of disputes just because the state court believes those disputes are better handled by some other means of dispute resolution. For example, this

Court held that the FAA preempts California Labor Code § 229 insofar as the state statute allowed litigation in court to collect wages "without regard to the existence of any private agreement to arbitrate." *Perry v. Thomas*, 482 U.S. 483, 484, 491 (1987) (quoting Cal. Lab. Code § 229 (West 1971)). This strongly suggests that California could not simply deem such an arbitration clause to be unconscionable and unenforceable to the extent it prevented an employee from suing in court to collect unpaid wages. *See Gold Rush*, 58 Bus. Law. at 1295. As one commentator noted:

> [T]he United States Supreme Court surely would review state courts' unconscionability rulings to the extent necessary to prevent the unconscionability doctrine from effectively nullifying the FAA with respect to a huge class of contracts. Indeed, the Court has twice stated that state courts may not "rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable, for this would enable the court to effect what . . . the state legislature cannot."

Stephen J. Ware, *Alternative Dispute Resolution* § 2.25(b), at 58 (West 2001) (citing *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687-88 n.3 (1996)); *Perry*, 482 U.S. at 492 n.9. That is, a court may not "decide that a contract is fair enough to enforce all its basic terms (price, service, credit), but not fair enough to enforce its arbitration clause." *Allied-Bruce Terminix Cos., Inc. v. Dobson*, 513 U.S. 265, 281 (1995).

Nonetheless, California courts have found the unconscionability doctrine to be a valuable tool to

invalidate arbitration contracts. In so doing, California has developed a reputation as "hostile" to arbitration. A recent empirical analysis conducted by Stephen Broome revealed that unconscionability challenges in California succeed against arbitration provisions with far greater frequency than any other type of contract provision. Stephen A. Broome, *An Unconscionable Application of the Unconscionability Doctrine: How the California Courts Are Circumventing the Federal Arbitration Act*, 3 Hastings Bus. L. J. 39 (2006). Broome identified 114 cases in which the California Courts of Appeal considered the unconscionability of arbitration contracts; in 53 of those cases, the arbitration provision was held unconscionable and unenforceable and another 13 found some aspect of the arbitration provision to be unconscionable and severed it. *Id.* at 44-45.[4] Forty-eight cases upheld the arbitration contract. By way of contrast, of the 46 unconscionability claims made outside the context of arbitration, 41 of the contracts were upheld by the courts, while only 5 were struck down as unconscionable. *Id.* at 47. By targeting arbitration provisions for exceptionally harsh review under the unconscionability doctrine, California courts violate Section 2 of the FAA, which demands that arbitration contracts be considered on "equal footing" with any other contract. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 225-26 (1987). *See also Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 at 36.

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[4] Broome's survey included cases decided from 1982 to 2006. The starting date was set by California's adoption of the currently existing unconscionability doctrine in *A & M Produce v. FMC Corp.*, 135 Cal. App. 3d 473, 486 (1982). Broome, 3 Hastings Bus. L.J. at 44 n.33.

II

CALIFORNIA COURTS REQUIRE MUTUALITY IN ARBITRATION CONTRACTS, BUT NOT OTHER TYPES OF CONTRACTS

What accounts for the difference in the courts' willingness to invalidate arbitration contracts as unconscionable as opposed to contracts in other contexts? Mostly, the culprit is a special test that California courts apply to unconscionability claims brought only against arbitration contracts. This test—the "mutuality test"—first appeared in *Stirlen v. Supercuts, Inc.*, 51 Cal. App. 4th 1519 (Cal. Ct. App. 1997), in which the court held that a contract that requires one party to arbitrate but not the other is so "one-sided" as to be unconscionable. *Id.* at 1532. The *Stirlin* court repeatedly labeled the contract between the parties as a "contract of adhesion," with the assumption that the label would be dispositive of the legal issues. *Id.* at 1533; see also *Kinney v. United Healthcare Servs.*, 70 Cal. App. 4th 1322, 1332 (Cal. Ct. App. 1999) (invalidating "unilateral obligation to arbitrate"). Yet this disdain of adhesion contracts itself betrays a certain bias.

> "The contract of adhesion is a part of the fabric of our society. It should neither be praised nor denounced. . . ." That is because there are important advantages to its use despite its potential for abuse. These advantages include the fact that standardization of forms for contracts is a rational and economically efficient response to the rapidity of market transactions and the high costs of negotiations, and that the drafter can

> rationally calculate the costs and risks of performance, which contributes to rational pricing.

Goodwin v. Ford Motor Credit Co., 970 F. Supp. 1007, 1015 (M.D. Ala. 1997) citing *Robertson v. The Money Tree of Alabama*, 954 F. Supp. 1519, 1526 n.6 and n.10 (M.D. Ala. 1997)).[5]

None of those advantages were even acknowledged by the California Supreme Court, however, and that court adopted the mutuality test in *Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal. 4th 83, 117 (2000), announcing that arbitration agreements must contain a "modicum of bilaterality." Since *Armendariz*, more than two-thirds of the courts

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[5] Richard Epstein explains why the "mutuality argument" cannot be a legitimate basis for declaring a contract unconscionable:

> A could not complain if B decided not to make him any offer at all; why then is he entitled to complain if B decides to make him *better off* by now giving him a choice when before he had none? If A does not like B's offer, he can reject it; but to allow him to first accept the agreement and only thereafter to force B to work at a price which B finds unacceptable is to allow him to resort (with the aid of the state) to the very form of duress that on any theory is prohibited. There is no question of "dictation" of terms where B refuses to accept the terms desired by A. There is every question of dictation where A can repudiate his agreement with B and hold B to one to which B did not consent; and that element of dictation remains even if A is but a poor individual and B is a large and powerful corporation. To allow that to take place is to indeed countenance an "inequality of bargaining power" between A and B, with A having the legal advantage as he is given formal legal rights explicitly denied B.

Epstein, *supra*, at 297.

that invalidated arbitration provisions did so because the provisions lacked mutuality. Broome, 3 Hastings Bus. L.J. at 50-51; see also Michael Schneidereit, Note, *A Cold Night: Unconscionability as a Defense to Mandatory Arbitration Clauses in Employment Agreements*, 55 Hastings L.J. 987, 1002 (2004) ("[I]n *Armendariz*, the court honed California unconscionabilty law into a weapon that could be used against mandatory arbitration agreements."). Indeed, in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), the California Supreme Court employed a form of the mutuality test to strike down class-arbitration waivers. In the court's view:

> [C]lass action or arbitration waivers are indisputably one-sided. 'Although styled as a mutual prohibition on representative or class actions, it is difficult to envision the circumstances under which the provision might negatively impact Discover [Bank], because credit card companies typically do not sue their customers in class action lawsuits.'

Id. at 161 (quoting *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094, 1101 (Cal. Ct. App. 2002), *cert. denied*, 537 U.S. 1226 (2002)). The court below relied on what it perceived as the one-sided nature of the contract in striking down Circuit City's class-arbitration waiver. *Gentry v. Superior Court*, 42 Cal. 4th at 470-72. Although some language in *Armendariz* suggests that lack of mutuality can be justified by "business realities," *Armendariz*, 24 Cal. 4th at 117, no lower court has yet identified a business reality sufficient to justify lack of mutuality in an arbitration agreement. Broome, 3 Hastings Bus. L.J. at 54, citing Michael G.

McGuinness & Adam J. Karr, *California's "Unique" Approach to Arbitration: Why This Road Less Traveled Will Make All the Difference on the Issue of Preemption Under the Federal Arbitration Act*, 2005 J. Disp. Resol. 61, 81 (2005). The mutuality test thus makes it significantly easier to challenge arbitration agreements as unconscionable.

Yet this Court held that "[t]he 'goals and policies' of the FAA . . . are antithetical to threshold limitations placed specifically and solely on arbitration provisions." *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. at 688. Given this straightforward holding, jurisdictions other than California have been unwilling to adopt a requirement of mutuality for arbitration agreements. *See, e.g., McNaughton v. United Health Care Servs. Inc.*, 728 So. 2d 592, 599 (Ala. 1999) (a mutuality approach relies on the "uniqueness of the concept of arbitration," "assigns a suspect status to arbitration agreements," and therefore "flies in the face of *Doctor's Associates*."). *See also Harris v. Green Tree Fin. Corp.*, 183 F.3d 173, 180 (3d Cir. 1999) ("substantive federal law stands for the proposition that parties to an arbitration agreement need not equally bind each other with respect to an arbitration agreement if they have provided each other with consideration beyond the promise to arbitrate"); *In re Pate*, 198 B.R. 841, 844 (S.D. Ga. 1996) (same result under Georgia law); *Munoz v. Green Tree Fin. Corp.*, 542 S.E.2d 360, 365 (S.C. 2001) ("the doctrine of mutuality of remedy does not apply here. An agreement providing for arbitration does not determine the *remedy* for a breach of contract but only the *forum* in which the remedy for the breach is determined.") (italics in original).

Meanwhile, outside the arbitration context, California courts do not demand mutuality either. *See Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, 65 Cal. App. 4th 1469, 1488-89 (Cal. Ct. App. 1998) (unilateral mortgage agreement upheld because "[w]here sufficient consideration is present, mutuality is not essential."); *Hillsman v. Sutter Cmty. Hosp.*, 153 Cal. App. 3d 743, 752 (Cal. Ct. App. 1984) (upholding unilateral employment contract where consideration requirement is properly met; a "mutuality of obligation" is unnecessary).

Thus, California's "mutuality" approach to determining substantive unconscionability in arbitration provisions differs from the standard used to analyze ordinary contractual provisions for unconscionability. Under the mutuality test, the court relies on its own speculation that the arbitral proceeding itself *might* impede a party's ability to obtain the requested relief. In the decision below, the court went even further, speculating that unidentified *other* potential class members might find it difficult to assert their rights. *Gentry*, 42 Cal. 4th at 461 ("Some workers, particularly immigrants with limited English language skills, may be unfamiliar with the overtime laws. Even English-speaking or better educated employees may not be aware of the nuances of overtime laws with their sometimes complex classifications of exempt and nonexempt employees.") (citation omitted).

For nonarbitration contractual provisions, however, California courts invalidate contracts as unconscionable only upon evidence of measurable, inevitable hardship if the disputed term is enforced. *See Phoenix Leasing Inc. v. Johnson*, No. A089871, 2001 WL 1324778, at *6 (Cal. Ct. App., Oct. 29, 2001)

(invalidating provision that would have given lender $208,000 of unaccrued interest); *Ilkhchooyi v. Best*, 37 Cal. App. 4th 395, 411 (Cal. Ct. App. 1995) (invaliding landlord's attempt to appropriate a portion of the sale price of a lease); *Carboni v. Arrospide*, 2 Cal. App. 4th 76, 83 (Cal. Ct. App. 1991) (invalidating interest rate of 200% per annum on a secured $99,000 loan); *Ellis v. McKinnon Broadcasting Co.*, 18 Cal. App. 4th 1796, 1806 (Cal. Ct. App. 1993) (invalidating contract that gave employer all of employee's sales commissions (which were the employee's sole compensation) that were received after the employee left the company when the sales were generated by the employee prior to his voluntary departure); *Johnisee v. Kimberlite Corp.*, No. A107341, 2005 WL 1249198 at *8 (Cal. Ct. App., May 24, 2005) (same).[6]

Because such class action waivers are upheld in most other courts, consumers who wish to sue national corporations (and their counsel) can circumvent those waivers by the simple mechanism of initiating a class action lawsuit in California. They need only to find a plaintiff in California to take the lead and file suit in state court, and then, once the lawsuit is under way, broaden the class action to include plaintiffs from around the country. *See* Aaron C. Gundzik & Rebecca Gilbert Gundzik, *Will California Become the Forum of Choice for Attacking Class Action Waivers?*, 25-FALL Franchise L.J. 56, 59 (2005). Thus, although California consumers and businesses are most obviously affected by the California courts' refusal to

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[6] These five cases are the only ones identified by Stephen Broome where California appellate courts invalidated contracts as unconscionable outside the arbitration context. *See* Broome, 3 Hastings Bus. L.J. at 56-58.

enforce class action waivers in arbitration, the true impact is national in scope and warrants this Court's review.

CONCLUSION

The California courts consistently hold arbitration agreements to a different standard when it comes to unconscionability, and the decision below represents the latest, and most extreme, example. Five years ago, then-Justice Janice Rogers Brown explained that "this court appears to be 'chip[ping] away at' United States Supreme Court precedents broadly construing the scope of the FAA 'by indirection,' despite the high court's admonition against doing so" and "urge[d]" this Court "to clarify once and for all whether our approach to arbitration law comports with its precedents." *Little v. Auto Stiegler, Inc.*, 29 Cal. 4th 1064, 1095 (2003) (Brown, J., concurring and dissenting) (quoting *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 122 (2001). This Court remains the only recourse to

reestablish the validity of arbitration agreements in the nation's most populous state.

The petition for writ of certiorari should be granted.

DATED: March, 2008.

Respectfully submitted,

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